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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

No. 741

SKENANDOA RAYON CORPORATION,
Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit and Brief in Support Thereof.

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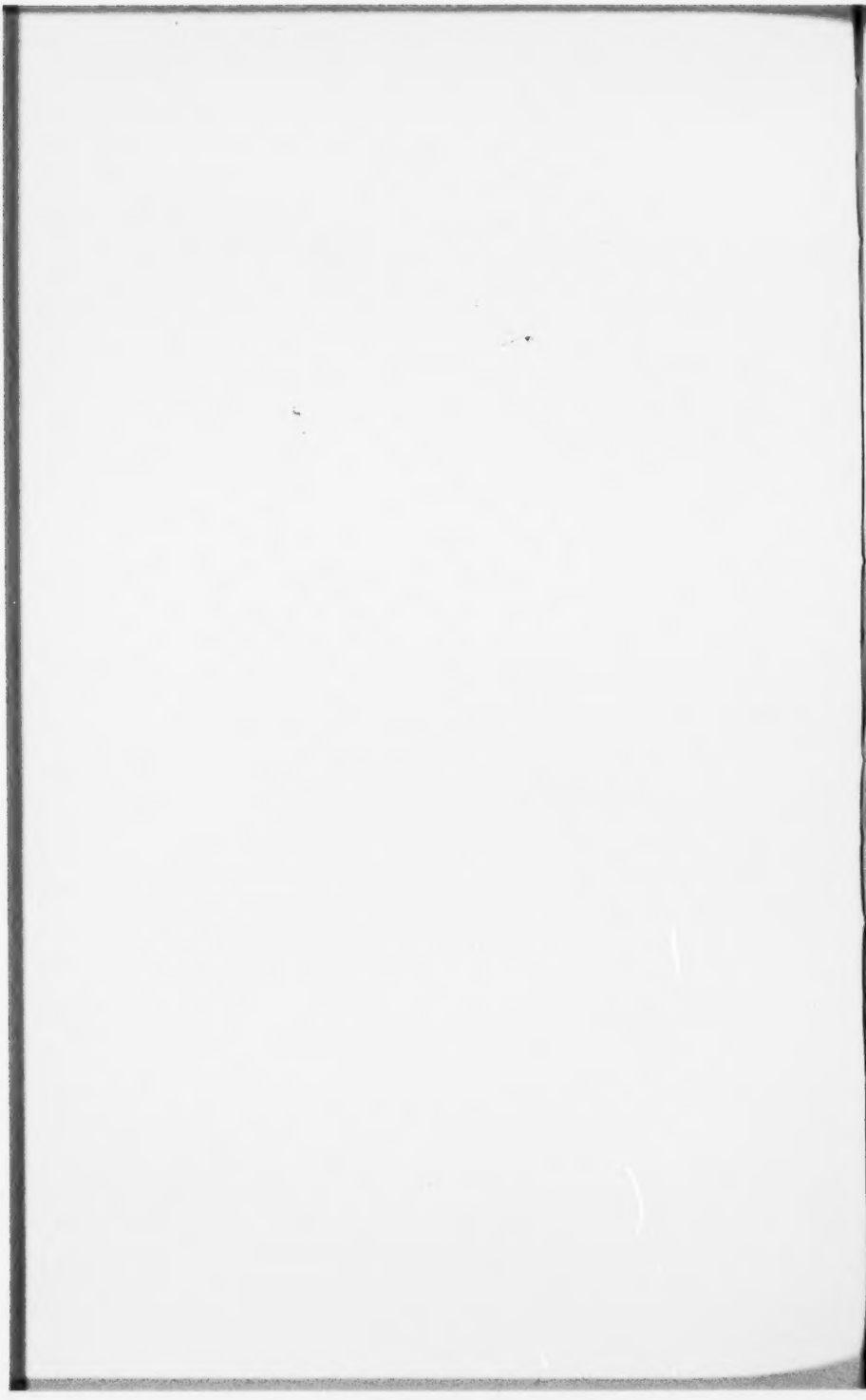

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

No. _____

SKENANDOA RAYON CORPORATION,

Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Petition for Writ of Certiorari to the United States Circuit Court of Appeals for the Second Circuit.

To the Honorable the Chief Justice and the Associate Justices of the Supreme Court of the United States:

Petitioner, Skenandoa Rayon Corporation, a Delaware corporation, respectfully petitions for a writ of certiorari of this court to review a judgment of the United States Circuit Court of Appeals for the Second Circuit, entered on August 16, 1941, which affirmed a decision of the United States Board of Tax Appeals entered February 6, 1941, sustaining the determination by the Commissioner of Internal Revenue of a deficiency of income tax of the petitioner for the taxable year 1937 in the amount of $54,873.09 and a deficiency in the excess profits tax for the same year in the amount of $706.87.

Questions Presented.

1. Whether, in computing the excess profits tax on undistributed profits imposed by Section 14 of the Revenue Act of 1936, petitioner is entitled to a dividends paid credit under Section 27 (a) or (e) of such Act upon the issuance and distribution to its preferred stockholders of additional shares of its new prior preferred stock in discharge of $40 per share of arrears of dividends on its old cumulative preferred stock?

2. Whether, under Sections 115 (a), (f), or (g) or 112 (c)(1) and (2) of the Revenue Act of 1936, the additional shares of new preferred stock issued in discharge of such arrears of dividends on old cumulative dividend preferred stock are taxable in the hands of the preferred stockholders who received such new preferred stock?

3. Whether, within the provisions of Sections 112 (b)(2) and (3), (g)(1)(D) and 115 (h)(1) of the Revenue Act of 1936, the issuance of the additional shares of new preferred stock in discharge of such arrears of dividends was an exchange of preferred stock solely for preferred stock or an exchange of stock or securities solely for stock or securities and a tax-free exchange (as an incident to a reorganization by recapitalization)?

4. Whether, under Section 23 (a) of the Revenue Act of 1936, attorneys' fees paid in connection with the discharge of arrears of cumulative dividends and the reclassification of capital stock incidental thereto are deductible from gross income?

Statutes Involved.

There are involved in this petition for certiorari the following provisions of the Revenue Act of 1936 (49 Stat. 1648): Sections 14 (a)(2) and (b); 23 (a); 27 (a), (e) and

(h); 112 (a), (b) (2) and (3), (c) (1) and (2), (g) (1); 115 (a), (f) (1) and (2), (g), (h) (1) and (2), and (j).*

Summary Statement of the Matter Involved.

The proceeding involves the question whether, in the year 1937, the holders of 5,553 shares of petitioner's preferred stock, entitled to cumulative dividends at the rate of $7. per year, received income taxable under the Sixteenth Amendment to the Constitution by the issuance to them, at par, with their consent, as a capitalization of $222,120 from petitioner's earnings for the year 1937, of 2,221.2 additional shares of petitioner's new prior preferred stock of the par value of $100 per share. The additional shares were issued in satisfaction of $222,120 arrears of dividend accumulated on the 5,553 shares of old preferred stock, the holders of which agreed to accept the additional shares of new stock in satisfaction of $40 arrears of dividend per share on their stock. If the issuance of the additional shares was income to the recipients, then, under Section 27* of the Revenue Act of 1936, petitioner is entitled to a "dividends paid credit."

As provided in Section 27, the amount of the dividends paid credit depends upon whether the income taxable to the preferred stockholders is the actual amount of petitioner's 1937 earnings capitalized or the fair market value of the additional shares issued to discharge the $40 arrears of dividend.

The Commissioner of Internal Revenue disallowed the credit. That determination was upheld by the Board of

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* The pertinent sections of the Revenue Act of 1936 are printed in the Appendix, beginning on page 39.

Tax Appeals, and the Circuit Court of Appeals affirmed the Board's determination.

Petitioner contends that the issuance of the additional shares of new prior preferred stock and the receipt thereof by the holders of 5,553 shares of its old cumulative preferred stock constituted income taxable to such stockholders under the Sixteenth Amendment, because the effect thereof was the equivalent of a distribution to them of $222,120 in cash or, alternatively, of a dividend in shares of the new preferred stock. Petitioner further claims that by the receipt of the 2,221.2 additional shares of new prior preferred stock the proportional interest of the recipients in the net assets of petitioner was increased over what it was before the preferred stockholders received the additional shares and that, therefore, under the rule as previously stated by this court (in *Koshland* v. *Helvering,* 298 U. S. 441), taxable income was received.

The question arises under the following circumstances:

As of July 1, 1937 petitioner had issued and outstanding 5,632 (out of 14,247 authorized) shares of its convertible preferred stock, the holders of which were entitled to cumulative preferred dividends at the rate of $7 per annum (198*). No dividends were declared on such issued preferred stock from January 1, 1931 to July 1, 1937, so that as of July 1, 1937 the arrears of dividend on such stock amounted to $45.50 per share, or an aggregate of $256,256 on the 5,632 shares outstanding (199).

During the years 1931 to 1936, inclusive, except for the year 1933, petitioner operated at a loss and at the end of 1936 had a deficit of $15,802.63 (245). The petitioner's net

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* Figures in parentheses, unless otherwise indicated, refer to folios in the transcript of the record in the Circuit Court of Appeals.

profits, before deduction for Federal income taxes, amounted to $320,392.51 at June 30, 1937 (244), more than enough to pay the full accumulated arrears of dividend, and amounted to $352,055.33 at the end of the year 1937 (244).

During the year 1937 there was in effect the Revenue Act of 1936. Section 14 of that Act imposed a surtax at graduated rates upon undistributed profits of corporations. The statute also provided for a dividends paid credit in determining the undistributed net income subject to tax. The credit under Section 27(a) was "the amount of dividends paid during the taxable year." Section 27(h) provided, however, that "If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title * * *, no dividends paid credit shall be allowed in respect to such part."

In April 1937 petitioner's officers and directors presented to the preferred stockholders a plan to discharge the $45.50 of arrears of dividend per share on petitioner's outstanding shares of preferred stock by issuing at par to preferred stockholders accepting the proposal .4 of a share of new (authorized and reclassified) 5% cumulative dividend prior preferred stock of the par value of $100 per share, plus $5.50 in cash (203-206).

The detailed machinery to carry out the plan included provisions for a recapitalization of petitioner and a reclassification of both the authorized and unissued shares, as well as the outstanding shares. The reclassification, among other things, changed the dividend rates (effective after the reclassification) from 7% to 5%. The plan provided for an exchange of each share of old 7% dividend stock for one share of the reclassified 5% dividend stock on a share-for-share basis. However, no tax question

arises from those exchanges. The tax question arises only from the receipt of the additional shares of new prior preferred stock.

In carrying out the plan the arrears of $45.50 per share were paid in part by transferring from earnings accrued in the year 1937 to capital the requisite amount ($222,120) as the consideration for the issuance of the new prior preferred stock at the rate of .4 of a share (or a total of 2,221.2 shares) in respect of each of the 5,553 shares of preferred stock then outstanding, the holders of which accepted the petitioner's proposal.

The plan emphasized that in accepting the proposal made therein the preferred stockholders "will thereby release, * * * their claim to all dividends accrued and in arrears on the outstanding Cumulative Preferred Stock" (219; see also 17, 172, 206 and 224).

The holders of 5,553 shares out of a total of 5,632 outstanding shares of preferred stock accepted the petitioner's proposal, leaving only the holders of 79 shares outstanding who did not accept the proposal (227). The holders of the 79 non-accepting shares were paid $45.50 per share, or a total of $3,594.50 cash (47).

The Commissioner eventually allowed petitioner a dividends paid credit for the amount distributed to the holders of the 79 shares and for the amount of the distribution at the rate of $5.50 per share made to the holders of the 5,553 shares who accepted petitioner's proposal (247).

The Commisioner, however, denied petitioner's claim for a dividends paid credit in respect of the $222,120, and rejected petitioner's contention that the 2,221.2 shares of new prior preferred stock of the par value of $100 each distributed at the rate of .4 of a share on each share of the

5,553 shares of preferred stock, the holders of which accepted petitioner's proposal, was in effect a distribution of $222,120 from petitioner's 1937 earnings.

It is not disputed, however, that pursuant to the stockholders' consent the amount of $222,120 was actually transferred from petitioner's 1937 earnings to capital account and that such sum constituted the capital received by petitioner as the consideration for the 2,221.2 shares of new prior preferred stock issued to discharge $40 per share of arrears of dividend (238, 240, 247; 36, 37).

In connection with the preparation and carrying out of the plan, petitioner employed attorneys who were paid $15,000, which was the reasonable value of the services (246). This expense was claimed as a deduction from petitioner's gross income, but was disallowed by the Comsioner (246).

The petitioner's proposal to issue .4 of a share of new preferred stock plus $5.50 in cash in satisfaction and discharge of $45.50 per share of arrears of dividend on the old preferred stock was also coupled with an offer to exchange one share of the (reclassified) preferred stock for one share of old preferred stock on a share-for-share basis. That exchange of shares (which involves no taxable gain), however, did not prevent the primary transaction from being, in substance and effect, a distribution of petitioner's 1937 earnings.

Looking only at matters of form and disregarding the substance, the Commissioner, the Board of Tax Appeals and the Circuit Court of Appeals concluded that the receipt of the 2,221.2 shares of new 5% prior preferred stock as the consideration for the release of $40 arrears of dividend per share on the old cumulative preferred stock, along with the exchange of shares of the new, re-

classified preferred stock for shares of the old preferred stock, on a share-for-share basis, was a "reorganization" within the meaning of Section 112(b)(2), (3) and (c)(1) and 112(g)(1)(D) of the Revenue Act of 1936, that it was a "non-taxable exchange" and that there was "no taxable gain" to petitioner's preferred stockholders. Accordingly, it was held below that the preferred stockholders did not receive taxable income and that petitioner should not be allowed any dividends paid credit in respect of the $222,120 transferred from petitioner's 1937 earnings (284; see also opinion and decision of the Circuit Court of Appeals appended to the Transcript of Record, pp. 128-131, fols. 128-133).

Likewise, both the Board of Tax Appeals and the court below affirmed the determination of the Commissioner that petitioner's legal expense of $15,000 in connection with the transaction was a capital expenditure in connection with a "recapitalization" and the expense was disallowed as an ordinary and necessary expense (285).

Jurisdictional Statement.

The jurisdiction of this court arises by virtue of the provisions of Section 240(a) of the Judicial Code (as amended) 28 U. S. C., Sec. 347; 26 Stat. 828, as amended by 36 Stat. 1157 and 43 Stat. 938. The judgment of the Circuit Court of Appeals for the Second Circuit was entered August 16, 1941 (Record, p. 131, fol. 133). This petition for certiorari was filed prior to November 16, 1941.

Rulings of the Circuit Court of Appeals and the Board of Tax Appeals.

The Board of Tax Appeals held that the transaction involved a non-taxable exchange within the purview of

Sections 112(b)(2), (3) and (c)(1) and 112(g)(1)(D) of the Revenue Act of 1936, and that, therefore, under the provisions of Section 27(h) of the same Act no dividends paid credit should be allowed to petitioner; in so ruling it held that the receipt of the new stock was not taxable in the hands of the stockholders under Section 115(a) and (g) of the Revenue Act of 1936 (248-285). The findings of fact of the Board of Tax Appeals appear in the record at folios 196 to 247. Although the petitioner contended, in the alternative, that the distribution of additional new prior preferred stock should be considered as constituting the distribution of a stock dividend under Sections 27(e) and 115(f) (362, 363), the Board Member confined his decision to the question whether the transaction should be given the effect of a cash dividend, taxable and paid (254). (See discussion *infra,* at pages 30 to 32.) The Board held that the expense for attorneys' services in carrying out the transaction was a capital expense and not deductible as an ordinary and necessary expense (284, 285). Petitioner applied for leave to reconsider or reopen the case, or in the alternative, to have the decision reviewed by the Board (286-309). On December 18, 1940 orders were handed down denying such application (310-315). The order of the Board of Tax Appeals upholding the Commissioner's claimed deficiencies in income and excess profits taxes in the respective amounts of $54,873.09 and $706.87 for the year 1937 was entered on February 6, 1941 (316-318).

The Circuit Court of Appeals affirmed the order of the Board of Tax Appeals (Record, p. 131, fol. 132).

Reasons Relied On For the Allowance of the Writ of Certiorari.

(1) The Circuit Court of Appeals has decided an important question in the administration of the federal income tax laws in a way probably untenable, because in conflict with the provisions of Sections 112 (c)(2) and 115 (a), (f) and (g) of the Revenue Act of 1936 and the decisions of this court.

The Circuit Court of Appeals (as well as the Board of Tax Appeals and the Commission) failed to appreciate that even if petitioner's proposal is considered as a distribution pursuant to a plan of reorganization and within Section 112 of the Revenue Act of 1936, as the court below held, nevertheless the distribution had the effect of the distribution of a taxable dividend under the provisions of Section 112(c)(2) which reads as follows:

> "(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property."

Neither the Circuit Court of Appeals nor the Board referred to the foregoing section of the Act, although it was expressly brought to their attention.

The court below also failed to apply the rules announced by this court in the decisions in three cases which were relied upon below. Those cases are:

Eisner v. *Macomber,* 252 U. S. 189;
Koshland v. *Helvering,* 298 U. S. 441;
Helvering v. *Gowran,* 302 U. S. 238.

Heretofore, in *Eisner* v. *Macomber, supra* (252 U. S. 189), this court has held that a distribution by a corporation of shares of common stock as a dividend on outstanding common stock does not constitute income taxable within the meaning of the Sixteenth Amendment, because after the distribution the shareholder held exactly the same interest in the net assets of the corporation as he did before the distribution of common stock was made.

In *Koshland* v. *Helvering, supra* (298 U. S. 441), this court held that a distribution of common stock in payment of a dividend on outstanding shares of preferred stock so increased the proportionate interest of the stockholder in the net assets of the corporation that after the distribution the stockholder had an interest different from that which his former stockholdings represented and that, therefore, the preferred stockholder had received income taxable under the Sixteenth Amendment, even though at that time Congress had not taxed such income.

In *Helvering* v. *Gowran, supra* (302 U. S. 238), this court held that a dividend on outstanding common stock payable in shares of preferred stock was also income which Congress could have taxed, but the taxation of which was prevented by reason of the provisions of Section 115(f) of the Revenue Act of 1928, as then in effect.

In the case at bar the corporation petitioner distributed shares of its new 5% prior preferred stock to holders of its old cumulative dividend preferred stock in discharge of arrears of dividend on such stock, the distribution being effected through a capitalization of earnings with the consent of the preferred stockholders accepting the distribu-

tion. While, so far as we know, such a distribution of new preferred stock on outstanding preferred stock has never before been considered by this court in determining whether or not the receipt of such preferred stock constitutes taxable income within the meaning of the Sixteenth Amendment and, therefore, is taxable under Section 115(a), (f) or (g) of the Revenue Act of 1936, nevertheless, it is respectfully submitted that, under the rules stated in the decisions mentioned, the distribution should be held to constitute income taxable to the recipients.

Both in the court below and before the Board of Tax Appeals petitioner urged that, considering the distribution as a distribution in stock (as an alternative to petitioner's primary contention that the distribution was the equivalent of a cash dividend), the receipt of the additional shares of preferred stock under the plan so changed the proportionate interest of the accepting preferred stockholder in the net assets of petitioner that taxable income had been received under the rule stated in *Koshland* v. *Helvering, supra.* Nevertheless, that contention was completely ignored and was not considered either by the Board or the court below.

It is impossible to reconcile the decision of the court below with the express provisions of Sections 112 (c)(2) and 115 (a), (f) and (g) of the Revenue Act of 1936 and the rules previously stated by this court.

It is not disputed that petitioner did distribute 2,221.2 additional shares of its new prior preferred stock to the holders of 5,553 shares of its old cumulative dividend preferred stock, that in the process, with the consent of such preferred stockholders, $222,120 of petitioner's 1937 earnings were consumed and that thereby the proportionate interest of the recipients of the new stock in the net assets of petitioner was substantially increased.

Therefore, it is respectfully submitted that the decision of the court below, affirming the Board's determination, is in conflict with the decision of this court in *Koshland* v. *Helvering, supra.*

(2) The Circuit Court of Appeals has decided an important question in the administration of the federal income tax law relating to distributions by corporations which has not been, but should be, settled by this court.

It is common knowledge that a large number of corporations have outstanding issues of cumulative dividend preferred stocks on which substantial amounts of arrears of dividends are unpaid. Such arrears, in the aggregate, amount to many millions of dollars and affect many thousands of holders of cumulative dividend preferred stocks. Various plans are being and will continue to be considered by the management of such corporations and the holders of such preferred shares to adjust and discharge the unpaid arrears by the issuance of additional shares of preferred stock, thereby capitalizing earnings. It is respectfully submitted that a decision on the plan presented in the case at bar will be helpful, not only to the Commissioner of Internal Revenue, but to the public generally, in knowing whether such plans will involve the receipt by the preferred stockholders of income taxable under the Sixteenth Amendment.

At present the situation is confusing, both to corporations and to the preferred stockholders, as well as to the Bureau of Internal Revenue. For example, upon the carrying out of the petitioner's plan, it is known that several holders of preferred stock reported the receipt of the additional shares of new prior preferred stock under the plan as income and paid a tax thereon for the year 1937. Petitioner has by circular letter advised all preferred stockholders of the decisions of the Board of Tax Appeals and

of the Circuit Court of Appeals herein, because of the bearing that such decisions may have on claims for refund of tax paid by petitioner's preferred stockholders.

In addition, petitioner has informed its preferred stockholders by a further circular letter that it would petition this court for a writ of certiorari to review the judgment of the Circuit Court of Appeals.

The importance of the problem of adjusting arrears of cumulative dividends on preferred stocks was recently indicated by the New York Court of Appeals in its opinion in the case of *Davison* v. *Parke, Austin & Lipscomb, Inc.*, 285 N. Y. 500 (decided May 29, 1941), where the court said (at page 506):

> "The issue thus presented is today one of great importance. It is common knowledge that during the past few years many corporations have been unable to pay dividends either upon common stock or preferred stock and that large amounts of unpaid cumulative dividends, constituting as they do a first charge upon future profits, have a tendency to discourage new investment. * * *"

Until the federal income tax question, such as is presented in the case at bar, has been finally determined by this court, there will remain unsettled questions with respect to the tax liability, not only of petitioner's preferred stockholders, but of many other corporations and preferred stockholders similarly situated, which should be settled by this court.

A brief in support of this petition is presented herewith.

Respectfully submitted,

HORACE R. LAMB,
Attorney for Petitioner.

Dated: November 12, 1941.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1941

No.

SKENANDOA RAYON CORPORATION,

Petitioner,

against

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

Brief in Support of Petition for Writ of Certiorari.

Opinions.

The opinion of the Circuit Court of Appeals for the Second Circuit (Circuit Judges L. HAND, SWAN and AUGUSTUS N. HAND, Judge SWAN writing) was filed July 31, 1941, and appears at page 128 of the record. It is reported in 122 F. (2d) 268. An opinion was delivered by the Board of Tax Appeals. It was written by Hon. RICHARD L. DISNEY and promulgated on November 26, 1940. It appears at page 83 of the record and is reported in 42 BTA 1287.

Jurisdiction.

The jurisdiction of this court arises by virtue of the provisions of Section 240(a) of the Judicial Code as amended by the Act of February 13, 1925, c. 229 (43 Stat. 938; 28

U. S. C. Sec. 347.) The judgment of the Circuit Court of Appeals for the Second Circuit was entered August 16, 1941 (Record, p. 131, fol. 133). This petition for certiorari and brief was filed prior to November 16, 1941.

The United States Board of Tax Appeals affirmed the determination by the Commisioner of Internal Revenue of the deficiency in the income tax of the petitioner for the taxable year 1937 in the amount of $54,873.09, and a deficiency in the excess profits tax for the same year in the amount of $706.87 (106). Such order was affirmed by the United States Circuit Court of Appeals for the Second Circuit (R., p. 131, fol. 133). The Circuit Court of Appeals for the Second Circuit (as well as the Board of Tax Appeals) held that the transaction was a tax free exchange (except for the cash payment of $5.50 per share) as an incident to a reorganization and recapitalization, within the provisions of Sections 112(b) (2) and (3), (c) (1), (g) (1) (D) and 115(h) (1). (R. 283, 284; R. pp. 128-131, fols. 128-132.)

The Facts.

The facts are stated in the petition at pages 4 to 8. The findings of fact of the United States Board of Tax Appeals appear in the record at pages 66-83, fols. 196-247.

ARGUMENT.

Summary.

The Circuit Court of Appeals has decided an important question in the administration of the federal income tax laws in a way untenable because in conflict with the ex-

press provisions of the Revenue Act of 1936 and the decisions of this court. Such question has not been, but should be, settled by this court.

The application of 1937 earnings as the consideration for the issuance of additional preferred stock in discharge of accumulated arrears of dividend was in effect the distribution of a cash dividend taxable to the recipients in the amount of said earnings under Section 115(a) or (g) of the Revenue Act of 1936. The Circuit Court of Appeals, however, did not so hold.

In the alternative, the additional preferred stock issued in discharge of accumulated arrears of dividend gave the recipient stockholders a proportional interest in the net assets of the corporation which was essentially different from their former interest, and, consequently, the preferred stockholders received income taxable under the Sixteenth Amendment. The decision below is in conflict with the provisions of Section 112(c) and 115(f) of the Revenue Act of 1936 and the decisions of this Court in *Koshland* v. *Helvering*, 298 U. S. 441, and *Helvering* v. *Gowran*, 302 U. S. 238.

The distribution of additional preferred stock was not a tax-free exchange incident to a reorganization by recapitalization under the provisions of Section 112 of the Revenue Act of 1936. The distribution was taxable under the express provisions of Section 112(c)(1) and (2). Legal expenses incurred in carrying out the transaction were operating expenses deductible from gross income under Section 23(a).

POINT I.

The application of $222,120 of petitioner's earnings for the year 1937, with the consent of the holders of 5,553 shares of petitioner's outstanding preferred stock, as the consideration for the issuance of 2,221.2 additional shares of petitioner's new preferred stock, or at the rate of .4 of a share in respect of each of the 5,553 consenting shares, in discharge of $40 of accumulated arrears of dividend, as set forth in the plan, was, in effect, the distribution of a cash dividend in the said amount from petitioner's earnings and profits accumulated during the year 1937.

There can be no doubt that the primary purpose of the proposal offered to petitioner's preferred stockholders under the plan was to effect an adjustment of the arrears of dividends on the outstanding shares of petitioner's old cumulative preferred stock. Such purpose was implicit (if not expressly stated) in all that was presented to the stockholders in the statements made in the plan and an accompanying letter addressed to petitioner's stockholders. The preferred stockholders were informed that "the arrears of accumulated dividend on the Convertible Preferred Stock, as at July 1, 1937, amount to $45.50 per share, or the aggregate of $256,256" (75, 162*). They were also told "The need for a plan of readjustment of the present capitalization arises principally as a result of the substantial amount of unpaid accumulated dividends on the outstanding Convertible Preferred Stock, which * * * should not be paid in cash at this time. Furthermore, it is also desirable that the Corporation retain its present working capital to finance the purchase of addi-

* Figures in parentheses, unless otherwise indicated, refer to folios in the transcript of the record in the Circuit Court of Appeals.

tional machinery and equipment desired to handle the substantial increase in the volume of business which is taking place." (203)

The plan and accompanying letter also stated (in heavy black type) that in accepting the plan "By making the exchange holders of the existing Cumulative Preferred Stock will thereby release, relinquish and discharge their claim to all dividends accrued and in arrears on the outstanding Cumulative Preferred Stock." (98, 171, 219)

The provisions of the plan and the effect thereof as a dividend distribution must have been clearly understood and found acceptable by an overwhelming majority of the holders of petitioner's preferred stock, because out of 5,632 issued shares, the holders of 5,553 shares, all but 79 shares, accepted the proposal. The preferred stockholders who accepted the proposal thereby elected to accept in discharge of the arrears of $45.50 per share .4 of a share ($40 face value) of additional new prior preferred stock, 5% convertible series, of the par value of $100 per share, and $5.50 in cash in respect of each issued share of old preferred stock then held. The holders of the 79 shares who did not accept the proposal elected to stand on their existing right to receive in cash the full arrears of $45.50 per share.

In this connection, it should be pointed out that Section 115 (f)(2) of the Revenue Act of 1936 (discussed *infra* at page 28) provides that where a distribution by a corporation is "at the election of any of the shareholders * * * payable either (A) in its stock, or * * * (B) in money or any other property * * *, then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid."

It cannot be disputed that under the law of the State of Delaware, where petitioner was incorporated, the right

to arrears of dividend on cumulative preferred stock is a contractual, property right of which the stockholder may not be deprived without his voluntary consent.

> *Keller* v. *Wilson,* 190 Atl. 115 (Del. Supreme Court, 1936).

The same rule has been held to apply in various other states.

> *Strout* v. *Cross, Austin & Ireland Lumber Company,* 283 N. Y. 406;
> *Davison* v. *Parke, Austin & Lipscomb, Inc., supra,* 285 N. Y. 500;
> *Lonsdale Securities Corporation* v. *International Mercantile Marine Co.,* 101 N. J. Eq. 554;
> *Patterson* v. *Durham Hosiery Mills,* 214 N. C. 806;
> *Harbine* v. *Dayton Malleable Iron Co.,* 22 N. E. (2d) 281 (Ohio Court of Appeals, 1939).

Therefore, in accepting petitioner's proposal, it may be truly said that the holders of petitioner's old preferred stock exercised their optional right to elect that the petitioner's earnings be distributed to them in cash as required by their existing contracts and without any understanding that it be re-invested in additional shares of petitioner's new prior preferred stock, or that the earnings be distributed subject to the agreement set out in petitioner's proposal.

For the purpose of determining whether the transaction had the effect of the distribution of a taxable dividend and constituted income taxable under the Sixteenth Amendment, there appears to be no valid ground for drawing a distinction between the distribution made to the holders of 79 shares who did not accept the petitioner's proposal

and the distribution made to the holders of the 5,553 shares who did accept the provisions of the plan. In either case, the amount distributed from petitioner's 1937 earnings with respect to each share of preferred stock was exactly the same; and it necessarily must have been the same in order to satisfy and discharge the contract right to be paid the arrears of $45.50 per share.

The shares of petitioner's new prior preferred stock were of the par value of $100 per share. Under Section 14 of the General Corporation Law of Delaware, capital stock having a par value can only be issued as fully paid stock if the corporation receives capital in a total amount equal to the par value of the shares issued. The transfer of $222,120 from petitioner's 1937 earnings to its capital account constituted the receipt of the capital for the issuance of 2,221.2 shares of new preferred stock of the par value of $100 each, so that the new shares were validly issued as fully paid and non-assessable shares. It necessarily follows, therefore, that the holders of the 5,553 shares of preferred stock who consented to the provisions of the plan and received the new stock, were, in effect, the recipients of a distribution from petitioner's 1937 earnings which was the equivalent of a cash distribution of $222,120.

In substance and effect, the transaction was the same as if $222,120 of petitioner's 1937 earnings had been distributed directly to the holders of the 5,553 shares and immediately on the receipt thereof such stockholders purchased from petitioner, at par, 2,221.2 shares of new preferred stock and made payment for the new stock with the cash distributed to them by petitioner.

There was nothing in the tax law which prevented petitioner from reaching an understanding with its own preferred stockholders prior to the distribution of a dividend

that the stockholder receiving such dividend would re-invest an agreed amount thereof (here it was $40 per share) in additional shares of petitioner's new prior preferred stock. In essence, that was the effect of the petitioner's offer to its preferred stockholders.

When the substance and effect of the transaction are understood, we believe it is plain that, with their express consent, the holders of 5,553 shares of petitioner's preferred stock received from petitioner's 1937 earnings the equivalent of $222,120, which is taxable income to them within the meaning of the Sixteenth Amendment, and that petitioner is entitled to a dividends paid credit in that amount.

There can be no doubt that in good faith petitioner transferred and applied $222,120 of its 1937 earnings to capital account as the consideration for the issuance of the 2,221.2 additional shares of its new prior preferred stock. By that action (to which the holders of 5,553 shares of petitioner's old preferred stock gave their consent) the stated amount was irretrievably taken from petitioner's earnings. The transaction effectively diminished petitioner's earned surplus by the amount stated. Furthermore, by issuing the 2,221.2 additional shares of stock, petitioner irrevocably assumed all of the burdens imposed upon it by the provisions of the certificates for the additional shares of new prior preferred stock and the stockholders who received such new shares thereby acquired additional proportionate interests in the net assets of the corporation and additional voting rights substantially different from those held prior to the receipt of the new shares (cf. *Koshland* v. *Helvering,* 298 U. S. 441, discussed *infra*).

The distribution of the additional shares of petitioner's new prior preferred stock in satisfaction of $40 of arrears

of dividend per share on petitioner's old preferred stock, we submit, was in all respects in accordance with the announced objects and purposes of the surtax on undistributed earnings, i. e., to compel corporations to distribute earnings so that the recipient stockholders could determine whether they wished to reinvest such earnings in additional shares of their corporation (See President Roosevelt's message to the 74th Congress, 2nd Session, March 3, 1936, and see Report of Ways and Means Committee, Report No. 2475, House of Representatives, 74th Congress, 2nd Session).

The learned court below and the Board of Tax Appeals, it appears, failed to appreciate the essential nature of the transaction from the point of view of the receipt of taxable income to the consenting preferred stockholders. Furthermore, the court below did not properly appraise the actual substance and effect of the transaction in relation to the applicable provisions of the Revenue Act of 1936.

It is our belief that the provisions of the 1936 act sustain petitioner's contentions. A dividend is defined in Section 115(a) of the act as follows:

> "The term 'dividend' when used in this title * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distribution made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made."

This court has said repeatedly that the substance and not the form of a dividend transaction is the controlling element.

U. S. v. *Phellis,* 257 U. S. 156;
Rockefeller v. *U. S.,* 257 U. S. 176.

Furthermore, a distribution actually made from earned surplus, as here, is a dividend irrespective of the form the distribution takes. As was observed by Judge SIBLEY in *Rose* v. *Little Investment Co.,* 86 F. (2d) 50, 51 (C. C. A. (5) 1936):

> "* * * The word 'dividend' means primarily the thing to be divided, and not the results of the division, and this meaning is observed in mathematics."

Instead of distributing $222,120 of its 1937 earnings in cash and receiving the same amount back from its stockholders as the payment for 2,221.2 shares of new preferred stock issued at par, petitioner, with the consent of the holders of 5,553 shares of its preferred stock, capitalized that amount of its 1937 earnings as the consideration for the issuance of the 2,221.2 new shares in satisfaction and discharge of $40 of the accumulated arrears of dividend per share on the consenting preferred stock. It seems irrefutable that such a transaction constituted a distribution of earnings by the petitioner corporation within the meaning of Section 115(a) of the Revenue Act of 1936.

It was a "distribution made * * * whether in money or other property * * * out of the earnings or profits * * * of the taxable year * * *."

It is not disputed that petitioner's net earnings for the taxable year 1937, after deductions for federal income taxes, amounted to $352,055.33 (244), so the earnings were more than adequate to cover the distribution as made.

The Revenue Act of 1936 made an addition to the definition of "dividends", as stated in prior revenue acts, by including in Section 115(a) a provision for a distribution

"(2) out of the earnings or profits of the taxable year * * * without regard to the amount of the earnings and profits at the time the distribution was made." According to the report of the Senate Finance Committee, the purpose of this addition was stated as follows:

> "Section 115(a)—Dividends Out of Current Earnings. In order to enable corporations without regard to deficits existing at the beginning of the taxable year to obtain the benefit of the dividends paid credit for the purposes of the undistributed profits surtax, Section 115(a) changes the definition of a dividend so as to include distributions out of the earnings or profits of the current taxable year. The amendment simplifies the determination by providing that distributions during the year, not exceeding in amount the current earnings, are dividends constituting taxable income to the shareholder and a dividends paid credit to the corporation. As respects such dividends the complicated determination of accumulated earnings or profits is rendered unnecessary." (Senate Finance Committee, Report No. 2156, 74th Congress, Second Session, pp. 18-19)

It is respectfully submitted, therefore, that the distribution of the 2,221.2 additional shares of petitioner's new prior preferred stock constituted the payment of a "dividend", as defined by Section 115(a), and it was the equivalent of a distribution in cash of $222,120 from the petitioner's earnings for the taxable year 1937.

Furthermore there should be noted the express provisions of Section 115(g) of the Revenue Act of 1936 providing that "If a corporation cancels or redeems its stock * * * at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or

cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend."

The exchange of 1.4 shares of new prior preferred stock (and $5.50 in cash) for 1 share of old preferred stock (which old stock was surrendered and cancelled) may also be considered as a cancellation of the old shares "in such manner as to make the cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend" and the "amount so distributed" held to "represent a distribution" of petitioner's 1937 earnings. So considered, the distribution is clearly to be treated as a taxable dividend.

In the following points we shall show that the distribution was taxable to the recipients under the Sixteenth Amendment.

POINT II.

Since the receipt of the 2,221.2 shares of petitioner's additional preferred stock under the provisions of the plan gave the recipient stockholders a proportional interest in the net assets of the corporation after the distribution, which was essentially different from such stockholders' former interest, the preferred stockholders receiving such distribution received income taxable under the Sixteenth Amendment.

There can be no dispute, we believe, that if the $222,120 of petitioner's 1937 earnings had been distributed in money, free of any understanding previously made with the preferred stockholders regarding reinvestment of the money in additional shares of petitioner's preferred stock, the recipients would have received a dividend which would constitute taxable income.

The primary contention of petitioner, both before the Board of Tax Appeals and the court below, was that the proposal contained in petitioner's plan and the acceptance thereof by the stockholders, when carried out by petitioner, was the equivalent of a distribution in cash.

As a second and alternative contention, petitioner's counsel took the position that the distribution of the 2,221.2 additional shares of preferred stock might be considered as constituting a stock dividend, inasmuch as the distribution gave the recipients a proportional interest in the net assets of the corporation different from the interest they held before the distribution.

The pertinent provisions of Section 115 (f)(1) of the Revenue Act of 1936 read as follows:

> "(f) Stock Dividends.
>
> (1) General Rule. The distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution."

We have seen that the holders of 79 shares of preferred stock did not accept petitioner's proposal, but elected to stand on their rights to be paid the full arrears in accordance with the provisions of the preferred stock preferences and free of any other understanding with petitioner, as proposed in the plan.

In the circumstances, therefore, we believe it may be truly said that the preferred stockholders had a right of election or option whether to stand on their contractual rights to be paid the dividend in money or to accept petitioner's proposal, and thereby elect to accept the divi-

dend partly in money and the balance (i. e., to the extent of $40 per share) in new preferred stock of petitioner.

Section 115(f)(2) of the Act contains the following provision:

> "(2) Election of Shareholder as to Medium of the Payment. Whenever a distribution by a corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or * * *(B) in money or any other property * * *, then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid."

Under the law of Delaware and in view of the provisions of the contract represented by the certificates for outstanding shares of preferred stock, it is clear that petitioner's preferred stockholders could insist upon their right to be paid the full amount of the arrears in cash.

> *Keller* v. *Wilson,* 190 Atl. 115 (Sup. Ct. of Del, 1936).

Petitioner, having pointed out in the plan that the arrears "should not be paid in cash at this time" (203), presented to the preferred stockholders an alternative basis for the satisfaction of the arrears of dividend by accepting the proposal stated in the plan.

In such circumstances, we believe it may properly be said that the preferred stockholder did have a right of election as to the medium of payment within the meaning of Section 115(f)(2) of the Revenue Act of 1936.

If we are correct in that view, then it necessarily follows that Congress intended that the distribution in stock, as well as in money, should constitute a taxable dividend

in the hands of all of the shareholders receiving the distribution "regardless of the medium in which paid".

In other words, that section of the act appears designed to prevent the drawing of any distinction between holders of the same class of stock, i. e., the holders of the 79 non-assenting shares and the holders of the 5,553 assenting shares, in determining whether "the money or any other property" (here shares of stock) received by either of the two groups of preferred stockholders shall be considered as taxable income.

It is also the petitioner's contention that within the rules stated by this court in *Koshland* v. *Helvering, supra* (298 U. S. 441), and *Helvering* v. *Gowran, supra* (302 U. S. 238), the distributions made by petitioner to discharge $40 of the arrears of dividend on 5,553 shares of petitioner's preferred stock is to be treated as income upon which Congress may levy a tax.

In *Koshland* v. *Helvering, supra,* shares of common stock were received by holders of cumulative preferred stock as dividends. It was held by this court that the receipt of such dividend of common stock on preferred stock constituted income within the meaning of the Sixteenth Amendment, because of the change in the proportional interest of the stockholder which resulted from the distribution. At that time, however, it did not appear that Congress had taxed the receipt of such income.

In *Helvering* v. *Gowran, supra,* dividends of preferred stock were distributed to common stockholders. This court held that under the rule announced in the *Koshland* case Congress could have taxed such dividends, although in the provisions of Section 115(f) of the Revenue Act of 1928 it had expressly provided that "a stock dividend shall not be subject to tax".

Apparently in the light of those decisions, when the Revenue Act of 1936 was enacted, Section 115(f) was changed, as above indicated, so that a distribution made by a corporation to its shareholders in stock may be treated as a dividend to the extent that it constitutes income to the shareholder within the meaning of the Sixteenth Amendment.

Therefore, where, as here, the distribution does increase the proportional interests of the recipient stockholders, it constitutes income to the shareholder within the meaning of the Sixteenth Amendment, which, under the provisions of Section 115(f)(1) and (2) of the Revenue Act of 1936, was taxable to the recipient stockholder.

The rule for which petitioner contends here appears to have been recently stated by the Circuit Court of Appeals for the Ninth Circuit in *Sprouse* v. *Commissioner of Internal Revenue,* —— F. (2d) ——, decided October 22, 1941 (unofficially reported in 414 CCH, Federal Tax Service, 1941, Vol. IV, paragraph 9703, page 10,647), where the court held that the test to be used in determining whether a stockholder who receives a dividend in stock of the distributing corporation has received income, is whether the distribution effects a change in the proportionate interest of the stockholders, thus following the rule stated by this court in *Koshland* v. *Helvering, supra,* and *Helvering* v. *Gowran, supra.* As hereinafter pointed out, the court below gave no consideration to the application of such test, although its attention was directed to such test, as stated in the decisions of this court.

In support of petitioner's alternative contention that the issuance of the additional shares of new preferred stock might be treated as the equivalent of a stock dividend (292), petitioner conceded on the record before the Board of Tax Appeals that the fair market value of the new preferred

stock, based upon the sale of a few shares made during the year 1937, was not less than $84 per share (297). That concession was apparently acceptable to counsel for the respondent Commissioner (367).

In the brief of petitioner in the court below, as well as before the Board, petitioner's counsel argued that in the alternative the distribution might be considered as a stock dividend (254).

However, in the opinion of the Board of Tax Appeals it was said that there was no evidence adduced to show fair market value and that the Board member confined his decision to the question whether the transaction should be given the effect of a cash dividend, taxable and paid (254).

In the light of that statement, petitioner's counsel then applied to the Board of Tax Appeals to have the case reconsidered or reopened to enable petitioner to produce competent proof of the fair market value in 1937 of the shares of petitioner's new preferred stock, or that the case and the opinion be reviewed by the full Board (286). That application was denied (310).

The court below held that the Board's denial of petitioner's application to reopen the case to enable petitioner to prove the fair market value of petitioner's new preferred stock at the time of its issue "rests in the sound discretion of the Board" and that "we can see no abuse of discretion" (R. 131, fol. 132). But the court apparently overlooked the fact that the denial of the application was in connection with the Board's holding that the distribution was a non-taxable exchange and as an incident of a reorganization within the purview of Section 112(b)(2), (3) and (c)(1) and 112(g)(1)(D) of the Revenue Act of 1936 (283, 284). It is apparent, therefore, that the Board's denial of petitioner's application to reopen the case was in the belief that further evidence relating to the market

value of petitioner's new preferred stock was either unnecessary or would not change the result. Thus the Board's denial of petitioner's application was not in the exercise of a discretionary power, but a part and parcel of the Board's (erroneous) determination that the distribution made by petitioner did not constitute taxable income; and that determination was made irrespective of whether the distribution was a cash dividend or a distribution of preferred stock.

POINT III.

The issuance and distribution by petitioner of 2,221.2 additional shares of its new prior preferred stock to the holders of 5,553 shares of its old preferred stock was not a tax-free exchange incident to a reorganization by recapitalization, under the provisions of Section 112 of the Revenue Act of 1936. The distribution was taxable under the express provisions of such Section 112. Legal expenses incurred in carrying out the transaction were operating expenses deductible from gross income.

Both the court below and the Board of Tax Appeals accepted the argument advanced by the Commissioner that the transaction was a recapitalization and that within the language of Section 112(b)(2) and (3) of the Revenue Act of 1936 the capital gain or loss to the preferred stockholders who accepted petitioner's proposal was limited to a recognition of the amount of cash received at the rate of $5.50 per share (261 and see opinion below, R. p. 129, fols. 129, 130).

However Section 112(c)(1) reads as follows:

> "(c) GAIN FROM EXCHANGES NOT SOLELY IN KIND.
>
> "(1) If an exchange would be within the provisions of subsections (b) (1), (2), (3), or (5) of this section

> if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, *but also of other property or money,* then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property." (Italics supplied.)

Apparently it was the provisions of the foregoing section upon which the court below and the Board of Tax Appeals relied for the conclusion that a gain from the distribution in settlement of arrears of dividend would be recognized only to the extent of $5.50 per share. Although it was brought to the attention of the court below, no consideration was given to the fact that not only was the $5.50 "other property or money" within the meaning of Section 112(c)(1), but also that the additional preferred stock distributed in settlement of dividend arrearages came within such subsection.

Notwithstanding that it was expressly pointed out in petitioner's brief below, no consideration was given to the provisions of Section 112(c)(2), which reads as follows:

> "(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection *but has the effect* of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. * * *" (Italics supplied.)

Under that section, even if the transaction is to be considered as a "distribution made in pursuance of a plan of reorganization", Congress has clearly indicated that if the distribution "has the *effect* of the distribution of a taxable dividend", which we believe is the case here, the

distribution must be taxed as a dividend where the distribution is not in excess (as is the case here) of the preferred stockholders' ratable shares of petitioner's undistributed earnings and profits accumulated in 1937 which, of course, was after February 28, 1913.

Section 112(c)(2) further indicates that even though in form and terminology there may be found a "plan of reorganization" by means of which a distribution of earnings is made, nevertheless it is necessary to examine such plan of reorganization to ascertain whether the "effect" of carrying out such a plan is to distribute a taxable dividend.

As we have shown above, the transaction between petitioner and its preferred stockholders plainly had the effect of distributing petitioner's 1937 earnings which increased the proportionate interest of the recipients in the net assets of petitioner. That being so, the distribution under the so-called "plan of reorganization" has had "the effect of the distribution of a taxable dividend," the amount of which is not in excess of the ratable shares of each preferred stockholder in petitioner's undistributed earnings accumulated after February 28, 1913.

Therefore, our situation comes squarely within the provisions of Section 112(c)(2); and even if the carrying out of the plan is to be considered as a technical "plan of reorganization", nevertheless the effect thereof was the distribution of a taxable dividend.

The court below took the view that there was an "exchange of preferred stock solely for preferred stock" in the same corporation within the meaning of Section 112(b)(2), which provides:

> "No gain or loss shall be recognized if common stock in the corporation is exchanged solely for common

stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation".

Rights to arrears of accumulated dividends on preferred stock, however, are not "preferred stock" within the meaning of Section 112(b)(2). Holders of cumulative dividend preferred stock have a vested right to unpaid arrears of dividend of which they can not be deprived without their consent (*Keller* v. *Wilson, supra,* 190 Atl. 115). Consequently, the issuance and receipt of the 2,221.2 shares of new preferred stock in settlement of arrears of dividend was not a receipt of preferred stock "solely in exchange for preferred stock", and the gain resulting from the exchange of the right to such arrears of dividend for such additional new preferred stock was taxable under Section 112(c)(1) and (2).

The lower court apparently went to great lengths in an effort to bring the transaction within the provisions of Section 112(b)(3), which provides:

> "(3) Stock for Stock on Reorganization.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization."

The court below said in its opinion (R. 130, fol. 131):

> "Even were we to accept the argument that the right to arrears of undeclared dividends was something in addition to the shares, and consequently the exchange was not 'solely' stock for stock, the taxpayers' path would be blocked by Section 112(b)(3). The stockholders' rights to dividend arrears, if treated as separate from the stock itself, must certainly be considered as 'securities in a corporation a party to a reorganization'—a curious 'security' to be sure,

> but nevertheless a 'security'. The rights represented by accumulations of preferred dividends are rights to share in future earnings of the corporation in preference to common stock; as such they represent such a continuity of interest in the affairs of the corporation as to constitute them 'securities'. Cf. *Lloyd-Smith* v. *Commissioner,* 116 F. 2d 642 (C. C. A. 2). It cannot be denied that there was a recapitalization and hence a 'reorganization' within the definition described by section 112(g)(1)(D). Hence section 112(b)(3) would preclude the recognition of gain or loss. Except to the extent of the cash payment, as provided in section 112(c)(1), the distribution to the old shareholders was not taxable."

In treating a right to arrears of dividend as a "security", it is submitted that the court below strained severely the ordinary meaning of the term "security".

It is elementary that until a dividend has been set apart or declared the stockholder has no rights whatever therein.

> *Gibbons* v. *Mahon,* 136 U. S. 549, 558;
> 11 Fletcher Cyclopedia Corporations, § 5321, pp. 781-786.

While holders of cumulative preferred stock have a vested right to accumulated arrears of dividends of which they can not be deprived without their consent and while such right, as demonstrated above, is distinguishable from the stock itself, such right to arrears of dividend does not constitute a "security". It has none of the attributes of a security. It is not a note, bond, debenture, stock or any other instrument commonly known as a security. It is more analogous to a contingent equitable claim, since until a dividend has been declared and profits are thereby set apart for its payment the stockholder has no claim at law. While the right to arrears of dividend might be within those inapplicable paragraphs of Section 112(b), concern-

ing the exchange or transfer of "property", such vested right is not "preferred stock" or "stock or securities" within paragraphs (2) and (3) of Section 112(b).

As stated in Article 112(a)-1 of Treasury Regulations 94, relating to corporate reorganizations, "the exceptions from the general rule requiring the recognition of all gains and losses, like other exceptions from a rule of taxation of general and uniform application, are strictly construed and do not extend either beyond the words or the underlying assumptions and purposes of the exception." Moreover, this Court has heretofore interpreted certain of such exceptions relating to corporate reorganizations strictly and has held that promissory notes or bonds received in exchange for property in a reorganization were not "securities" within the meaning of that term.

> *LeTulle* v. *Scofield,* 308 U. S. 415;
> *Pinellas Ice Co.* v. *Commissioner,* 287 U. S. 462;
> *See also Helvering* v. *Bashford,* 302 U. S. 454.

Accordingly, there would seem to be no valid ground for the holding of the court below that a right to arrears of dividend is a security, especially since the effect thereof is to broaden the restrictive exceptions to the general rule of taxability, thereby increasing tax exemptions.

The Board of Tax Appeals took a somewhat different view for holding that the exchange came within the provisions of Section 112(b)(2), (3) and (c)(1), saying:

> "* * * One consideration appears for both the release of the old stock and the release of the right to accumulated dividends.
>
> "From all this we conclude that a consideration for the exchange is not separable between old stock and the right to dividends accumulated thereon. * * *"
> (276, 277)

The basic error in the court below and before the Board of Tax Appeals was the failure to examine the substance of the transaction, rather than its form. The Circuit Court of Appeals, as well as the Board, erred in failing to hold that the *effect* of the distribution was a taxable dividend within the meaning of Section 112(c)(2) of the Revenue Act of 1936. Neither the court below nor the Board gave any consideration to the provisions of that section.

Since the distribution of the new prior preferred stock in settlement of $40 of arrears of dividend per share on the old preferred stock was not a tax-free exchange and is taxable in the hands of the recipients, the sum of $15,000 paid by petitioner for legal expenses in carrying out the transaction is clearly an ordinary and necessary operating expense which petitioner is entitled to deduct from its gross income in accordance with Section 23 (a). The distribution of taxable dividends on the petitioner's outstanding preferred stock and the securing of working capital to provide for current expansion does not appear to be an ordinary and necessary expense incurred in carrying on petitioner's trade or business.

CONCLUSION.

For the reasons stated, a Writ of Certiorari to the Circuit Court of Appeals for the Second Circuit should issue.

Dated: November 12, 1941.

Respectfully submitted,

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APPENDIX.

Pertinent Provisions of the Revenue Act of 1936.

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) DEFINITIONS.--As used in this title—

* * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) IMPOSITION OF TAX.—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c):

7 per centum of the portion of the undistributed net income which is not in excess of 10 per centum of the adjusted net income.

12 per centum of the portion of the undistributed net income which is in excess of 10 per centum and not in excess of 20 per centum of the adjusted net income.

17 per centum of the portion of the undistributed net income which is in excess of 20 per centum and not in excess of 40 per centum of the adjusted net income.

22 per centum of the portion of the undistributed net income which is in excess of 40 per centum and not in excess of 60 per centum of the adjusted net income.

27 per centum of the portion of the undistributed net income which is in excess of 60 per centum of the adjusted net income.

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) EXPENSES.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business including a reasonable allowance for salaries or other compensation for personal services actually rendered; traveling expenses (including the entire amount expended for meals and lodging) while away from home in the pursuit of a trade or business; and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) DIVIDENDS PAID CREDIT IN GENERAL.—For the purposes of this title, the dividends paid credit shall be the amount of dividends paid during the taxable year.

* * *

(e) TAXABLE STOCK DIVIDENDS.—In case of a stock dividend or stock right which is a taxable dividend in the hands of shareholders under section 115 (f), the dividends paid credit with respect thereto shall be the fair market value of the stock or the stock right at the time of the payment.

* * *

(h) NONTAXABLE DISTRIBUTIONS.—If any part of a distribution (including stock dividends and stock rights) is

not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part.

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) GENERAL RULE.—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) EXCHANGES SOLELY IN KIND.—

* * *

(2) STOCK FOR STOCK OF SAME CORPORATION.—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

(3) STOCK FOR STOCK ON REORGANIZATION.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * *

(c) GAIN FROM EXCHANGES NOT SOLELY IN KIND.—

(1) If an exchange would be within the provisions of subsections (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then

the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

* * *

(g) DEFINITION OF REORGANIZATION.—As used in this section and section 113—

(1) The term "reorganization" means (A) a statutory merger or consolidation, or (B) the acquisition by one corporation in exchange solely for all or a part of its voting stock: of at least 80 per centum of the voting stock and at least 80 per centum of the total number of shares of all other classes of stock of another corporation; or of substantially all the properties of another corporation, or (C) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor or its stockholders or both are in control of the corporation to which the assets are transferred, or (D) a recapitalization, or (E) a mere change in identity, form, or place of organization, however effected.

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) DEFINITION OF DIVIDEND.—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

• • •

(f) STOCK DIVIDENDS.—

(1) GENERAL RULE.—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

(2) ELECTION OF SHAREHOLDERS AS TO MEDIUM OF PAYMENT.—Whenever a distribution by a corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or in rights to acquire its stock, of a class which if distributed without election would be exempt from tax under paragraph (1), or (B) in money or any other property (including its stock or in rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1)), then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.

(g) REDEMPTION OF STOCK.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

(h) EFFECT ON EARNINGS AND PROFITS OF DISTRIBUTIONS OF STOCK.—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in another corporation shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or

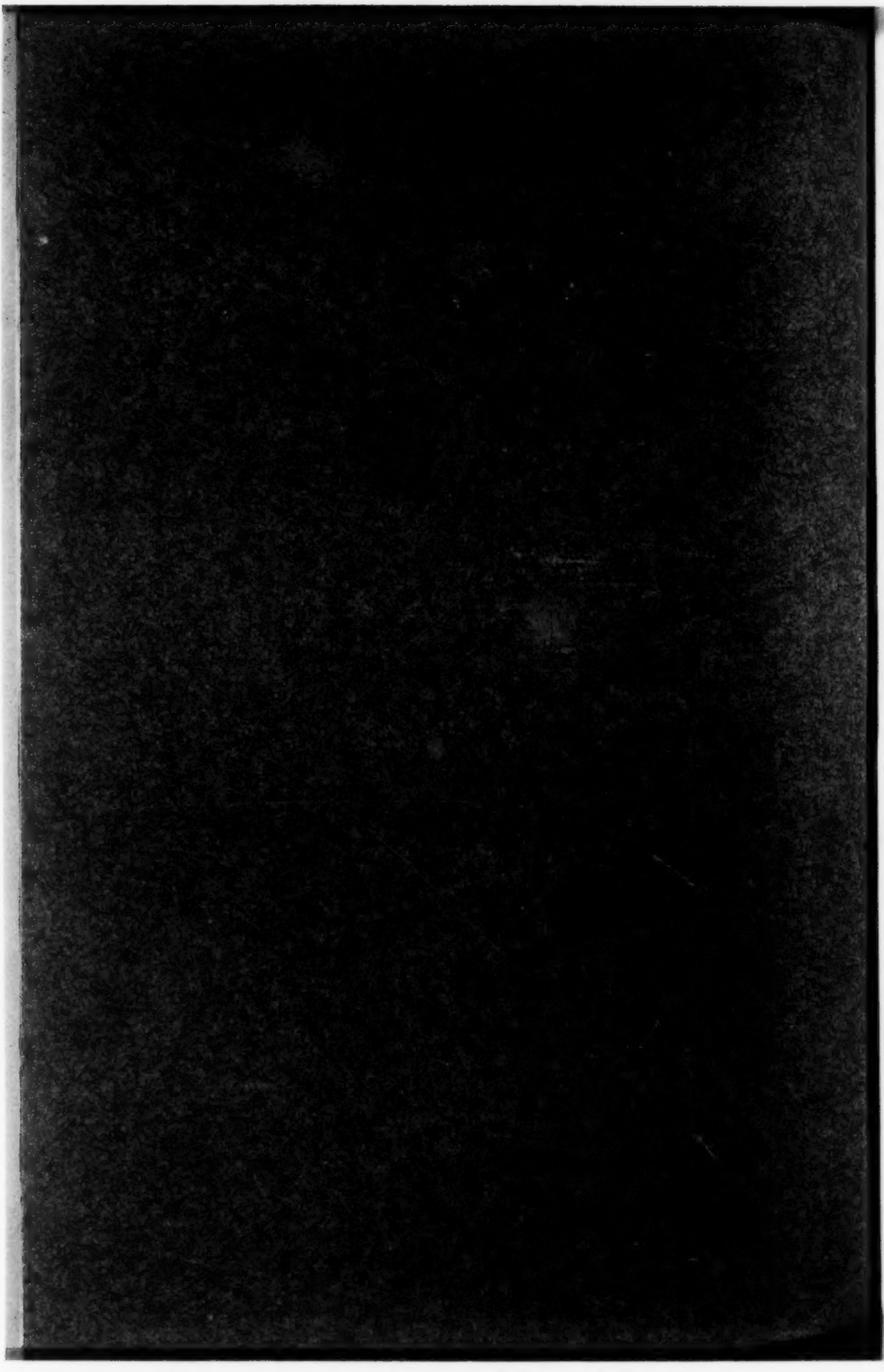
(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

* * *

(j) VALUATION OF DIVIDEND.—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

[redacted]



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430028—41

In the Supreme Court of the United States

OCTOBER TERM, 1941

No. 741

SKENANDOA RAYON CORPORATION, PETITIONER

v.

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the United States Board of Tax Appeals (R. 65–95) is reported in 42 B. T. A. 1287. The opinion of the Circuit Court of Appeals (R. 128–131) is reported in 122 F. (2d) 268.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on August 16, 1941 (R. 131–132). The petition for a writ of certiorari was filed November 14, 1941. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Pursuant to taxpayer's "Plan of Recapitalization" and reorganization, holders of taxpayer's 7 per cent preferred stock, of no par value, exchanged that stock for 1.4 shares of new 5 per cent preferred stock, of $100 par value, and $5.50 in cash, surrendering their right to unpaid accumulated dividends of $45.50 per share on the old stock.

The question is whether a dividends paid credit, except for the cash paid, is allowable under Section 27 of the Revenue Act of 1936. This depends upon whether the transaction was an exchange of stock for stock in a reorganization or was a dividend paid.

STATUTE INVOLVED

The applicable sections of the statute are set out in the appendix, *infra,* pp. 9–14.

STATEMENT

The facts found by the Board (R. 66–83) may be summarized as follows:

Prior to July 1, 1937, taxpayer, a Delaware corporation, had outstanding 5,632 shares of 7 per cent cumulative preferred stock, without par value, upon which dividends of $45.50 per share were in arrears on July 1, 1937 (R. 66–67). During the year 1937, the corporation made net profits of more than enough to pay the arrears of dividends on its preferred stock but it desired to retain funds for expansion of the business (R. 67).

In April, 1937, the taxpayer devised a plan of recapitalization (R. 67). Stockholders were notified by circular letter (R. 67–69) and a printed copy of the plan, designated "Plan of Recapitalization" (R. 69–74) was sent to all stockholders (R. 67). Under the plan, preferred stockholders were offered $5.50 cash and 1.4 shares of new 5 percent preferred stock, of a par value of $100, in exchange for one share of old preferred stock (R. 71–73) on the understanding that by accepting the plan and exchanging the preferred stock any claim to dividends accrued and in arrears would be released, relinquished and discharged (R. 73). Common stockholders were to receive common stock of a par value of $5 for each share of no par common stock held (R. 70).

The offer was accepted by holders of all but 79 shares of the old preferred stock and in July 1937, the directors declared the plan of recapitalization operative (R. 76). The plan was thereupon carried out and the holders of 5,553 shares of the old preferred stock, then reclassified into the same number of Class A preferred, surrendered their certificates and received 7,774.2 shares of the new cumulative prior preferred stock and $30,541.50 in cash, at the rate of $5.50 for each old share surrendered. The holders of 79 shares of old preferred then held the same number of shares of Class A preferred and the holders of 343,542 shares of common stock of no par value became holders of a

similar number of shares of reclassified common stock of a par value of $5 per share (R. 79).

In connection with the preparation and carrying out of the "Plan of Recapitalization", the taxpayer paid its attorneys $15,000 (R. 82).

The Commissioner, in auditing the tax return filed for the year 1937, allowed the taxpayer's claim of a dividends-paid credit to the extent of $5.50 cash per share paid on the old preferred stock, $30,541.50, but denied the claim of a credit for $222,120 (representing $40 per share on 5,553 shares of the old preferred stock). He also denied a dividends-paid credit of $3,160, representing $40 per share on the 79 shares of stockholders who did not consent to the plan, but abandoned that position on brief. He disallowed the deduction of $15,000 for attorneys' fees on the ground that it was a capital expenditure. (R. 83.)

The Board held that the transaction was a nontaxable exchange and therefore no dividends-paid credit, other than that allowed and conceded by the Commissioner, was allowable to the taxpayer (R. 95). It also held that attorneys' fees were a capital expenditure and not deductible (R. 95). The court below affirmed (R. 128–132).

ARGUMENT

The only question presented to the Board of Tax Appeals was whether in effect the transaction was a payment of a cash dividend (R. 85). The Board

held that the transaction was an exchange of old stock for new, plus cash, that the transaction was a nontaxable exchange, and that therefore, no dividends-paid credit was allowable.[1]

1. The Circuit Court of Appeals agreed with the Board that the transaction was a tax-free exchange as an incident to a reorganization by recapitalization (R. 129). Since Section 112 (g) (1) (D) defines the term "reorganization" to include a recapitalization, it is plain that the transaction was a tax-free exchange. But in any event, the mere fact that the transaction was an exchange, whether taxable or not, is a sufficient answer to the taxpayer's contention that a payment of a dividend was here involved.

The holding of the court below, therefore, that the item in dispute was not a taxable dividend but, rather, was a tax-free exchange (R. 129) was, without more, dispositive of the case. Nevertheless, the court below took cognizance of additional arguments advanced by the taxpayer relating to the issue whether, assuming that the transaction were not a tax-free exchange, the stockholders received taxable income (R. 130). On this issue too, the court below held against taxpayer, and, accord-

[1] The Commissioner allowed a dividends-paid credit to the extent of the $5.50 cash paid on each old share and to the extent of $40 additional per share paid to the nonassenting old stockholders (R. 83). These credits are not involved here.

ingly, petitioner seeks further review in this Court on the ground that the decision of the court below in this respect is in conflict with *Eisner* v. *Macomber,* 252 U. S. 189, *Koshland* v. *Helvering,* 298 U. S. 441, and *Helvering* v. *Gowran,* 302 U. S. 238 (Pet. 9–12; 29–30). But whatever the difficulties arising from these cases, it is clear that they are not material since their application does not relate to the holding of the court below. Those cases involved dividends; in the instant case, as the court below held, there was no dividend but only a tax-free exchange.

2. The other grounds urged by petitioner are equally without merit. Petitioner's contention (Pet. 18–26) that the transaction was a distribution of a cash dividend is based on a factual premise explicitly rejected by the Board of Tax Appeals and the court below. Although there was a single transaction whereby 1.4 new shares plus $5.50 in cash were issued for each old share, taxpayer contends for an allocation of the additional .4 share to the accrued dividends on the old shares. The concurrent findings (R. 90, 130) below that the transaction was single and indivisible are clearly correct and require no further review.

Petitioner also urges (Pet. 26–32) that the additional .4 shares of new stock should be considered either as a cash dividend or as a stock dividend. The court below adequately answered both contentions. It pointed out (R. 130) that no election was

given to the stockholders to take either cash or stock and that there was therefore no basis for regarding the distribution as a cash dividend. With respect to the alleged stock dividend, the Circuit Court of Appeals pointed out that a holding to that effect would be no aid to the taxpayer since it had failed to prove the value of the stock (R. 131). The question of value was pointedly brought to the taxpayer's attention in the Board hearing (R. 122), and hence the failure to show the value was not an inadvertence.

Petitioner's contention that the transaction was not a tax-free exchange (Pet. 32–38) is mistakenly based on Section 112 (c) (2) of the Revenue Act of 1936. That provision deals exclusively with the portion of the consideration which is made taxable by Section 112 (c) (1). Thus Section 112 (c) (2) deals only with money or property other than stock or securities and is not applicable to the additional stock issued in the exchange here involved.

Taxpayer's final contention that the legal expenses incurred in carrying out the exchange are deductible depends upon the acceptance of its theory that this transaction was a taxable dividend. Since it was not, the legal expenses clearly are not deductible.

CONCLUSION

The decision of the court below that the transaction was a tax-free exchange in reorganization is correct and presents no question of general im-

portance. The only conflict asserted by petitioner relates to a dictum of the court below. The petition should therefore be denied.

Respectfully submitted.

CHARLES FAHY,
Solicitor General.

J. LOUIS MONARCH,
Acting Assistant Attorney General.

NEWTON K. FOX,
Special Assistant to the Attorney General.

DECEMBER 1941.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 14. SURTAX ON UNDISTRIBUTED PROFITS.

(a) DEFINITIONS.—As used in this title—

(1) The term "adjusted net income" means the net income minus the sum of—

(A) The normal tax imposed by section 13.

(B) The credit provided in section 26 (a), relating to interest on certain obligations of the United States and Government corporations.

* * * * *

(2) The term "undistributed net income" means the adjusted net income minus the sum of the dividends paid credit provided in section 27 and the credit provided in section 26 (c), relating to contracts restricting dividends.

(b) IMPOSITION OF TAX.—There shall be levied, collected, and paid for each taxable year upon the net income of every corporation a surtax equal to the sum of the following, subject to the application of the specific credit as provided in subsection (c): [Graduated rates are provided.]

* * * * *

(c) ADJUSTED NET INCOME LESS THAN $50,000.—

(1) SPECIFIC CREDIT.—If the adjusted net income is less than $50,000, there shall be allowed a specific credit equal to the portion of the undistributed net income which is in excess of 10 per centum of the adjusted net income and not in excess of $5,000, such credit to be applied as provided in paragraph (2).

(2) APPLICATION OF SPECIFIC CREDIT.—If the corporation is entitled to a specific credit, the tax shall be equal to the sum of the following:

(A) A tax computed under subsection (b) upon the amount of the undistributed net income reduced by the amount of the specific credit, plus

(B) 7 per centum of the amount of the specific credit.

* * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) EXPENSES.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *.

* * * * *

SEC. 27. CORPORATION CREDIT FOR DIVIDENDS PAID.

(a) DIVIDENDS PAID CREDIT IN GENERAL.—For the purposes of this title, the dividends paid credit shall be the amount of dividends paid during the taxable year.

* * * * *

(c) DIVIDENDS IN KIND.—If a dividend is paid in property other than money (including stock of the corporation if held by the corporation as an investment) the dividends paid credit with respect thereto shall be the adjusted basis of the property in the hands of the corporation at the time of the payment, or the fair market value of the property at the time of the payment, whichever is the lower.

* * * * *

(e) TAXABLE STOCK DIVIDENDS.—In case of a stock dividend or stock right which is a taxable dividend in the hands of shareholders under section 115 (f), the dividends paid credit with respect thereto shall be the fair market value of the stock or the stock right at the time of the payment.

* * * * *

(h) NONTAXABLE DISTRIBUTIONS.—If any part of a distribution (including stock dividends and stock rights) is not a taxable dividend in the hands of such of the shareholders as are subject to taxation under this title for the period in which the distribution is made, no dividends paid credit shall be allowed with respect to such part.

* * * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) GENERAL RULE.—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

(b) EXCHANGES SOLELY IN KIND.—

* * * * *

(2) STOCK FOR STOCK OF SAME CORPORATION.—No gain or loss shall be recognized if common stock in a corporation is exchanged solely for common stock in the same corporation, or if preferred stock in a corporation is exchanged solely for preferred stock in the same corporation.

(3) STOCK FOR STOCK ON REORGANIZATION.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

* * * * *

(c) GAIN FROM EXCHANGES NOT SOLELY IN KIND.—

(1) If an exchange would be within the provisions of subsection (b) (1), (2), (3), or (5) of this section if it were not for the fact that the property received in exchange consists not only of property permitted by such paragraph to be received without the recognition of gain, but also of other property or money, then the gain, if any, to the recipient shall be recognized, but in an amount not in excess of the sum of such money and the fair market value of such other property.

(2) If a distribution made in pursuance of a plan of reorganization is within the provisions of paragraph (1) of this subsection but has the effect of the distribution of a taxable dividend, then there shall be taxed as a dividend to each distributee such an amount of the gain recognized under paragraph (1) as is not in excess of his ratable share of the undistributed earnings and profits of the corporation accumulated after February 28, 1913. The remainder, if any, of the gain recognized under paragraph (1) shall be taxed as a gain from the exchange of property.

* * * * *

(g) DEFINITION OF REORGANIZATION. As used in this section and section 113—

(1) The term "reorganization" means * * * (D) a recapitalization, * * *.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) DEFINITION OF DIVIDEND.—The term "dividend" when used in this title (except in section 203 (a) (3) and section 207 (c) (1), relating to insurance companies) means any distribution made by a corporation to

its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

* * * * *

(f) STOCK DIVIDENDS.—

(1) GENERAL RULE.—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

(2) ELECTION OF SHAREHOLDERS AS TO MEDIUM OF PAYMENT.—Whenever a distribution by a corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or in rights to acquire its stock, of a class which if distributed without election would be exempt from tax under paragraph (1), or (B) in money or any other property (including its stock or in rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1)), then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.

(g) REDEMPTION OF STOCK.—If a corporation cancels or redeems its stock (whether or not such stock was issued as a stock dividend) at such time and in such manner as to make the distribution and cancellation or

redemption in whole or in part essentially equivalent to the distribution of a taxable dividend, the amount so distributed in redemption or cancellation of the stock, to the extent that it represents a distribution of earnings or profits accumulated after February 28, 1913, shall be treated as a taxable dividend.

(h) EFFECT ON EARNINGS AND PROFITS OF DISTRIBUTIONS OF STOCK.—The distribution (whether before January 1, 1936, or on or after such date) to a distributee by or on behalf of a corporation of its stock or securities or stock or securities in another corporation shall not be considered a distribution of earnings or profits of any corporation—

(1) if no gain to such distributee from the receipt of such stock or securities was recognized by law, or

(2) if the distribution was not subject to tax in the hands of such distributee because it did not constitute income to him within the meaning of the Sixteenth Amendment to the Constitution or because exempt to him under section 115 (f) of the Revenue Act of 1934 or a corresponding provision of a prior Revenue Act.

As used in this subsection the term "stock or securities" includes rights to acquire stock or securities.

* * * * *

(j) VALUATION OF DIVIDEND.—If the whole or any part of a dividend is paid to a shareholder in any medium other than money the property received other than money shall be included in gross income at its fair market value at the time as of which it becomes income to the shareholder.

* * * * *

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